Accountants &
business advisers

The evolution programme

Finding the funding – adopting a flexible approach

What you should be thinking about now

Whilst there has rarely been a better time to raise finance for expansion or acquisition, it is a very different matter for start-ups for which it is likely to be a difficult and frustrating process.

Despite the fact that UK interest rates are at historically low levels, it is a difficult environment in which to raise external funding for new ventures. The banks want security in the form of assets or personal guarantees and are unwilling to lend large amounts to start-ups. Venture capitalists are extremely risk averse and only interested in established businesses with a track record of profitability (operating profits of £1 million are increasingly regarded as the entry level for VCs).

But very few businesses are set up without any external funding. It is the lifeblood of any business and, unless you have access to sufficient funds to set up and run the business until you start to make a profit, you could be one of the 30% of UK enterprises that fail within three years.

So how can new businesses – without the large asset bases or trading history necessary to make a bank feel comfortable about lending large amounts - bridge the 'equity gap'?

PKF Top Tip - When starting a business, only do what you are good at. Be prepared to invest in your own venture because prospective funders will need evidence of your personal commitment.

What's going to be right for you – options to think about

The key to successful fundraising is to adopt a flexible approach and to consider a range of sources and existing assets such as pension schemes.

Our experience is that around 90% of start-ups are funded by either the assets of the founding directors, family and friends or by bank loans secured with personal guarantees.

Founder directors – personal assets

In addition to the more traditional sources of funding outlined below, you could also consider using the funds from existing pension schemes to set up a Small Self-Administered Scheme (SSAS), a trust that is set up under pension rules.

A SSAS effectively enables you to invest your pension monies in ways that can be very helpful to a fledgling business. Specifically, your pension fund could be used to invest in the shares of the business giving you tax relief on the amount invested.

The added benefit is that any shares held within the pension fund are free of Capital Gains Tax when you eventually sell the business.

The SSAS can also make loans to the business which can be much more cost effective than borrowing from a bank.

Family and friends – shares

A common source of funding is family and friends although the Financial Services Authority (FSA), the independent body that regulates the financial services industry in the UK, is increasingly vigilant about protecting the financial interests of individuals.

Issuing shares in your company to family and friends will enable you to raise long-term capital, but inevitably means that others will have a say in how your business is run. The main advantage of issuing shares is that the money brought into the company does not need to be repaid and no interest is charged. Investors look for gain from the growth and profitability of the company so you will need to have a good business plan to persuade them that you can succeed.

Your family could also lend the business money on either a short or long-term basis. The advantages are that family members are less likely to require security and any profits will stay in the family. However, if the business does not thrive, it could put family relationships under pressure.

Banks – loans and overdrafts

Banks and other asset-based lending companies are most easily persuaded to part with funds if you have money or assets against which you can provide a personal guarantee.

Term loans are most suitable for funding fixed assets such as machinery and office equipment where the amount that you need is not going to change. The disadvantage of a bank loan is that you have to maintain your cash flow to make the repayments. If you fail to do so, the lender can put your business into receivership.

A more flexible form of borrowing is an overdraft, as you only pay interest on the amount used. Overdrafts are best used for funding short-term running costs rather than long-term finance as they are repayable on demand and are more expensive than term loans.

Government support – loan guarantees and grants

Another funding source is the Government which provides support for businesses in two main ways: loan guarantees and grants.

The Government's Small Firms Loan Guarantee Scheme provides loans of up to £100,000 (£250,000 if your business has been trading for more than two years). In return for a premium of 2% a year payable to the DTI, the Government will guarantee 75% of the total capital value of the loan to the lending bank.

Local and regional organisations such as Business Link, Regional Development Agencies (RDAs), Chambers of Commerce, and the Learning and Skills Councils (LSCs) offer grants.

These are usually one-off payments for a proportion of the costs of specific planned projects (known as 'matched funding') and a business has to meet a range of criteria to be eligible.

Venture capitalists and business angels – equity finance

The DTI also sponsors a number of regionally-based venture capital funds for smaller businesses which are managed by commercial fund managers. The maximum investment in a company is £250,000 although secondary funding to a total investment of £500,000 is available.

There is, however, no such thing as 'free money' and venture capitalists look for rounded management teams, a well developed business model, and a clearly thought through strategy before investing in you. There is also the downside that, although the VCs will not usually get involved in the day-to-day running of the business, they are looking for long-term options and will own a substantial part of your company and probably have a controlling vote on key decisions affecting their interest.

Business angels are individual private investors who tend to invest small amounts of money - between £10,000 and £100,000 – in small businesses with high growth potential. If you like being your own boss, this approach may not suit you as a significant proportion of your profits will go to your investor.

PKF Top Tip - Look at all the funding sources and options and be prepared to mix and match to obtain the amount you need. Avoid putting all your funding eggs into one basket and being dependent on a single source.

Frequently asked questions

Q. Which methods of raising finance are the most tax efficient?

A. Several of the methods discussed have tax benefits. Grants are not taxable as income; there is tax relief on loan interest; and an SSAS is a tax-efficient vehicle. There is also the Enterprise Investment Scheme (EIS), the purpose of which is to help certain types of small higherrisk unquoted trading companies to raise capital by providing a range of tax reliefs for investors in qualifying shares in these companies.

Q. In which regions are you most likely to be able to secure a government grant?

A. The main regions are currently South Yorkshire, Merseyside and the South West although a level of assistance is available in other areas. Have a look at www.j4b.co.uk, the UK grants database for government and European funding for small and medium sized businesses.